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Market Dominant Product Prices First-Class and Standard Mail Discover Financial Services	Docket No. MC2011-19
Market Dominant Product Prices Discover Financial Services (MC2011-19) Negotiated Service Agreement	Docket No. R2011-3

Public Representative Reply to Postal Service Response to Comments

(April 16, 2013)

On April 11, 2013, the Postal Service filed an ad hoc response to the comments of Valpak and the Public Representative in this docket.[1] They introduce new facts that are important to the Commission's evaluation of the amended NSA. They also introduce so much confusion into the analysis of this NSA, and Market Dominant NSAs generally, that they warrant a reply.

To see how far afield the Postal Service's justifications for Market Dominant NSAs have gone, it is necessary to go back to basics. NSAs are intended to change the behavior of the mailer contracted with by offering that mailer discounts or rebates if it changes its behavior in the way targeted. If the rebate offered doesn't cause the mailer to change its behavior, as is the case here, the rebate is simply a gift.

Standard of review. In its comments on the original NSA in this docket, and again in its comments on the amended NSA, the Public Representative observed that the original NSA uses rebates and penalties that are so small relative to the total

[1] Response of the United States Postal Service to Public Representative's and Valpak's Comments, April 11, 2013 (Postal Service Response). Order Nos. 1676 or 1684 made no provision for reply comments.

volume of First-Class and Standard Regular letters that DFS sends that it is simply not rational for DFS to change the total volume of such mail that it sends based on those rebates and penalties. As the Public Representative has demonstrated, and the Commission concurs, these rebates and penalties would only affect the volume of such mail that DFS sends if DFS had own-price elasticities that were off the charts for any postal product and utterly unexplainable for monopoly products.[2]

In its Response, the Postal Service cites the Public Representative's analysis but makes no attempt to rebut it. Nor does it attempt to rebut the unavoidable conclusion--shared by the Public Representative and the Commission--that the roughly $ 5 million in rebates that DFS received in Contract Year One didn't affect the volume of First-Class and Standard mail that DFS sent that year. The Postal Service's Response also concedes that letting DFS count the Priority Mail volumes that it will use to send out credit card kits as proxy volume for First-Class Mail under the NSA contract will not affect either the volume of First-Class Mail or the volume of Priority Mail that DFS will send going forward.[3] The Postal Service, therefore, tacitly concedes not only that the $5 million that DFS received in Contract Year One was a gift, but that going forward, this NSA will bestow an additional gift on DFS—the reduced risk that DFS will run afoul of the NSA's penalty clause. *Neither gift will change the volume of any kind of mail that DFS sends.*

So why let this amended NSA go forward? Because, the Postal Service says, it will serve the interests of science.[4] Since all sides are satisfied that this amended NSA

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[2] See FY 2012 ACD at 157-58; Comments of the Public Representative in Response to Order No. 654 (February 7, 2011) at 13.

[3] In its Response, at 5, the Postal Service says "it would be irrational for DFS to base its decision to use priority Mail on the benefit that it would gain as a party to an amended NSA."

[4] The Postal Service puts it this way, at page 7 of its Reply Comments:

> As the Postal Service gains experience with these agreements, learns more about customer reactions, and as it accumulates more data against which it can evaluate theories, models, and estimation techniques, it should be better equipped to provide the Commission with a superior methodology.

is unlikely to have any effect on the volume of either First-Class, Standard, or Priority Mail that DFS sends, one might well ask what we are we likely to learn from this experiment. The best we can hope for is that it will verify that there are a handful of ways that the Postal Service can give rebates to a mailer without changing the amount of mail that it sends. The connection between such a benefit and the statutory standard that this amended NSA is supposed to satisfy ranges from extremely tenuous to non-existent. Section 3622(c)(10)(A) says that an NSA that must increase net contribution." This NSA doesn't. It therefore doesn't pass statutory muster.

The Postal Service says that the Commission's approval of the original NSA was "not predicated primarily on it improving the net financial position of the Postal Service, but, rather on permitting the postal Service to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume," citing Order No. 694, at 15-16.[5] The Postal Service's Response asserts that

> *any* insight that the Postal Service would gain to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume, or compensate for the loss of contribution, would make the Postal Service better off in the long run as a result of this agreement (emphasis supplied).

As the Commission has acknowledged, the Postal Service has yet to identify any "insights" that it has gained from the original NSA into how to slow the decline of First-Class Mail volumes. See FY 2012 ACD at 158. It seems to assume, however, that if it were ever does share such insights with the Commission it will thereby meet the requirement that the NSA increase must increase net contribution under section 3622(c)(10)(A).

[5] At the cited pages, the Commission concludes that approving the original NSA will

> allow management to enhance its tools to slow the overall declining trend for First-Class Mail volume. As a result of the experience and information that Postal Service management will gain while this negotiated service agreement remains in place, the Commission finds that the Postal Service will better off in the long run as a result of the agreement.

That isn't the standard that the Commission applied. The Commission didn't say that *any* insight that the Postal Service would gain by going forward with the original NSA is enough to meet section 3622(c)(10), however meager the insight, or how little relevance the insight gained may be to the issue of demonstrating net contribution. If that were the applicable standard, it wouldn't just lower the net for Market Dominant NSAs involving First-Class Mail, it would remove the net entirely.

There is a great need for clarity by the Commission in response to this argument if the integrity of its review of Market Dominant NSAs is to be preserved. Section 3622(c)(10)(A) says that one of two kinds of affirmative showings by the Postal Service is required to approve an NSA: it must either improve the Postal Service's operations[6] or it must increase net contribution. Operational changes are irrelevant to this NSA. That leaves a showing that the NSA will increase net contribution as the only basis for approving it.

It would be almost impossible to design an NSA that involves First-Class Mail so poorly that one would learn nothing whatever about the decline of First-Class Mail volume with respect, at least, to the particular mailer involved. But that isn't the standard set out in section 3622(c)(10)(A). That section requires that *the NSA under review* increase net contribution, not that it merely be part of a process of trial and error that might lead to the formulation at some future time of an NSA that actually does increase net contribution. The Commission's broad language about the experimental value of the original NSA is not legally sufficient under section 3622(c)(10)(A) if it is not accompanied by at least a tacit finding that the *NSA under review* will increase net contribution.

The Commission language at pages 15-16 of Order No. 694 concerning the original NSA's value as an experiment must be interpreted as merely a supplemental finding to its legally required finding that the NSA under review will have increased net

[6] Section 3622(c)(10)(A)(i) says the NSA must enhance mail preparation, processing, transportation, or other functions.

contribution by its completion date. The Commission concluded in its FY 2012 ACD that the original NSA had not yielded a net contribution in Contract Year One, and did not comply with this requirement. It relies on the prospect that the NSA could yet meet the net contribution requirement in its remaining contract years as its reason for holding a remedy in abeyance. FY 2012 ACD at 158.

Meeting the standard of review. To be approved, section 3622(c)(10)(A) requires that the Postal Service show that a Market Dominant NSA will increase net contribution. Rule 3010.42(c) requires that the Postal Service support its conclusions regarding net contribution by providing a detailed forecast of the mailer's volumes and revenues with and without the rebate. The Commission has identified the methodology that the Postal Service must employ in making its estimates of mailer-specific own-price elasticities.[7] With respect to the DFS NSA, specifically, the Commission has directed the Postal Service to provide an estimate of the degree to which it concludes that DFS's own-price elasticities differ from the system averages for First-Class and Standard letter mail and to explain those differences in its data collection report.[8] The Postal Service waives aside the latter two requirements by observing that "different factors have more relative importance to different customers,"[9] and therefore it "does not measure how elasticities differ by customer."[10]

Merely reciting the truism that "different factors have more relative importance to different customers" is not an analysis of the NSA mailer's likely volume response to a rebate. It provides no support whatever for a conclusion that the mailer's response will increase contribution. The closest the Postal Service has come in this docket to providing an analysis to support its net contribution estimate was to provide a list of factors that it considered in arriving at its estimate. The list includes 1) the economic

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[7] See Docket No. MC2004-3 Opinion and Further Recommended Decision.

[8] See Order No. 694 at 23, Item 9.

[9] Postal Service Response at 7.

[10] Discover Financial Services Negotiated Service Agreement Data Collection Report (April 1, 2011 – March 31, 2012), answer to Question No. 9.

recovery, (2) consumer credit, (3), employment, (4) the system-wide growth rates, (5) consumer spending, (6), household income, (7) household debt, (8) current trends, (9) its understanding of DFS's business, and (10) expectations of market and economic conditions.[11]

Analysis doesn't begin, support is not provided, and section 3622(c)(10)(A)(i) is not met, unless the Postal Service says *what conclusion it came to* with respect to a particular factor, and explains *how that conclusion affected its estimate* of the NSA mailer's response to the rebate. Otherwise, a list of factors that were considered is nothing but boilerplate. It might as well be a macro on a word processor. To meet its burden of showing that any Market Dominant NSA will increase net contribution, the attorney assigned to write the notice asking for approval of the NSA could simply click on the macro, paste it into his notice, and be done.

It is easy to illustrate the uselessness of reciting a list of factors considered in forecasting the net contribution that an NSA will make if the Postal Service keeps *what conclusion it came to* with respect to any particular factor a secret. In this docket, the Postal Service lists "current trends" as a factor that it considered. But it doesn't say *what conclusion it came to* when it considered the effect of "current trends" on DFS's likely response to rebates. In its comments on the original NSA, the Public Representative provided statistics that showed that currently, there was explosive growth in the mailing of credit card solicitations by the financial services industry. The Public Representative then showed that DFS's credit card solicitations would only have to grow at less than one-tenth the rate of the industry average to qualify for rebates.[12] If the Postal Service actually did consider "current trends" in arriving at its forecast of

[11] The first seven factors were recited in the Postal Service's Response to CHIR No. 2. The last three factors were added in the Postal Service's Reply Comments at 3.

[12] Clarification of Public Representative Analysis in Response to Reply Comments (February 23, 2011) at 3.

DFS's before-rebate volumes, one can only wonder how its forecast was so at odds with those trends.

The Postal Service also recites that it considered "expectations of market and economic conditions." The Public Representative quoted a prominent analyst of financial services markets who asserted that credit card solicitations at that time were rebounding from the deep recession volumes, and that "there is a sense of optimism around the credit card industry which is spreading." Id. The Postal Service badly underestimated DFS's before-rebates volumes by extrapolating an historic trend that was depressed by the past recession. Here, too, the Postal Service claims to have considered "expectations of market and economic conditions" in arriving at its forecast of DFS's before-rate volumes. If the Postal Service actually had considered "expectations of current market and economic conditions" in arriving at its forecast of DFS's before-rebate volumes, one can only wonder why its forecast ran counter to those expectations.

These two examples illustrate that providing a list of factors considered without saying what conclusion the Postal Service reached concerning any of those factors, or what impact any of those conclusions had on the Postal Service's forecast of NSA volumes, provides no support whatever of a Postal Service estimate that an NSA will increase net contribution. Because there is no meaningful support for a conclusion that this amended NSA will increase net contribution in Contract Year Three, the Commission should withhold its approval.

Significant rebalancing of risk. The original NSA sets a First-Class Mail revenue threshold for each contract year. DFS will incur a small penalty if its First-Class Mail revenue falls below that threshold. The Postal Service argues that we should not regard its request to count Priority Mail volume toward that threshold as any real change to the original NSA. At page 4 of its Response, it says that

> The volume shifting to Priority Mail was already included in the Postal Service's volume and revenue trends and expectations for current and future economic conditions affecting DFS' First-Class Mail. Crediting DFS'

> First-Class volume for this higher contribution product does not change the value of the agreement.

It conveniently overlooks the fact that the amendment will reduce the risk that DFS will not meet the threshold below which it must pay a penalty. While the amount of proxy First-Class volume for which DFS would now get credit is small, DFS itself says that the reduction in risk that it will have to pay that penalty is significant. At page three of its Comments,[13] DFS observes

> One might also ask why, if this number is so small, does DFS even care? The answer is that DFS's threshold in year three—which is ***25% above its baseline threshold***—is so high that Discover is going to have to stretch very hard to make it (which, from the Postal Service's point of view, is exactly what the Postal Service wants DFS to do), and thus even a very small number could make the difference between reaching and not reaching the threshold (emphasis in the original).

By DFS' own account, it will have to "stretch hard" to meet the adjusted threshold.[14] It feels the need to reform the agreement that it made in 2011in an effort to reduce that risk however it can. In DFS' own eyes, the amendment would significantly shift the balance of risk that was struck under the original agreement.

In its Response, the Postal Service admits that the amount of Priority Mail that DFS will mail would not have been affected by the original NSA and will not be affected by amending the NSA. Therefore, the Postal Service will reduce DFS' risk of incurring a penalty under the amended NSA without getting anything but a pat on the back from DFS in return.

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[13] Comments of Discover Financial Services (March 26, 2013).

[14] The original revenue threshold was to be 20% above baseline in Contract Year Three. The fact that DFS is expecting to have to meet a threshold that is 25% above baseline can only mean that DFS expects the threshold to be adjusted upward for failing to send enough First-Class Mail in Contract Year Two.

The “unforeseen,” “windfalls,” and “fairness.” Prior to the filing of the Postal Service’s ad hoc Response, the story behind the amendment that we had been told was that after the original NSA agreement had been signed,[15] DFS made an “unforeseen business decision”[16] to distribute some credit card kits by Priority Mail rather than by First-Class mail. DFS argued that this unforeseen decision would benefit the Postal Service, but would also make it more likely that DFS would pay a penalty under the original agreement for allowing its First-Class Mail postage to fall below the revenue threshold provided in the original agreement. DFS argues that incurring a penalty for its good deed would be “unfair” to it, and a “windfall” to the Postal Service.

We now learn from the Postal Service’s Response that both sides expected this shift of First-Class to Priority Mail from the beginning, and understood its impact on the “value of the agreement” all along. Response at 4. This changes the narrative from one where DFS should be rewarded for making an “unforeseen” business decision that will confer an unexpected benefit on the Postal Service to a narrative where DFS realizes two years into the agreement that the risk of incurring a penalty under the NSA is greater than it originally thought, and it now needs to change the agreement to avoid giving back to the Postal Service in Contract Year Three some of the $ 5 million windfall that it collected in Contract Year One. This is a “heads I win, tails you lose” approach to contracting with the Postal Service. Letting DFS off the hook now would not be fair to the Postal Service or to the mailing public. If the Commission is inclined to uphold this NSA, it should uphold only the original agreement.

[15] See Comments of Discover Financial Services, March 26, 2013, at 1-2.

[16] See Amendment to Negotiated Service Agreement between the United States Postal Service and Discover Financial Services accompanying letter dated March 8, 2013, from Brandy Osimokun to Shoshana Grove, Secretary, Postal Regulatory Commission.

Respectfully submitted

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